

**SECTION 457 DEFERRED COMPENSATION PLANS OF STATE AND LOCAL  
GOVERNMENT AND TAX-EXEMPT EMPLOYERS  
AFTER THE SMALL BUSINESS JOB PROTECTION ACT OF 1996  
AND THE TAXPAYER RELIEF ACT OF 1997  
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**1. INTRODUCTION.**

Section 457 plans are nonqualified, deferred compensation plans established by state and local government and tax-exempt employers. These employers can establish either eligible (covered by 457(b)) or ineligible (covered by 457(f)) plans, and are subject to the specific requirements and deferral limitations of section 457 of the Internal Revenue Code of 1986 ("Code"). Certain other types of plans established by state and local government and tax-exempt employers are not subject to the requirements of section 457, however. The purpose of this article is to provide an overview of section 457, identify the differences between an eligible and an ineligible section 457 plan, and discuss those plans which are excepted from the rules and requirements articulated in section 457 and the regulations thereunder. This article will also try to highlight specific situations where plans may not be in compliance with section 457.

As originally enacted, the rules governing section 457 plans were developed based on nonqualified plan concepts. Section 457 plans therefore are subject to different, and often less stringent regulations than are qualified plans, which must comply with complex rules to assure parity in who they cover, and how much can be deferred. An attendant feature of section 457 plans is that they may provide less security to participants than do qualified plans.

Starting on January 1, 1997, important statutory changes to section 457 resulting from the passage of H.R. 3448, THE SMALL BUSINESS JOB PROTECTION ACT OF 1996 ("SBJPA"), affect all eligible section 457(b) plans, and, in particular, eligible section 457(b) plans of state and local government employers. New section 457(g) now requires that all amounts deferred under eligible section 457(b) plans of state and local government employers be set aside in trust for the exclusive benefit of plan participants. This is in direct contrast to the law prior to the enactment of the SBJPA, which still subjects eligible section 457(b) plans of tax-exempt employers to section 457(b)(6) of the Code, and, therefore, still requires that they be unfunded. Section 2.D of this article provides a complete overview of this important requirement for government plans. This article will discuss, where appropriate throughout the article, the additional changes made to section 457 under the SBJPA and more recently by ' 1071 of the Taxpayer Relief Act of 1997 ("TRA '97").

Most recently, in Notice 98-8, 1998-4 I.R.B. 6 (January, 1998) we issued substantive guidance concerning the revisions made to eligible section 457(b) deferred compensation plans by the SBJPA and the TRA '97. Specifically, Notice 98-8 provides guidance on the trust requirements applicable to state and local government employers maintaining a ' 457(b) plan, including the requirements for custodial accounts and annuity contracts; in-service distributions from a section 457(b) plan if the total amount payable to the participant does not exceed \$5,000; an additional election to defer commencement of distributions from a section 457(b) plan and the

cost of living adjustments to the \$7,500 limitation on maximum deferrals under a section 457(b) plan. This article will discuss in detail these new changes to section 457.

Finally, this article updates **SECTION 457 DEFERRED COMPENSATION PLAN OF STATE AND LOCAL GOVERNMENT AND TAX-EXEMPT EMPLOYERS**, published in the Exempt Organizations Continuing Professional Education, Technical Instruction Program for FY 1997, Topic M, page 189, as well **SECTION 457 DEFERRED COMPENSATION PLAN OF STATE AND LOCAL GOVERNMENT AND TAX-EXEMPT EMPLOYERS AFTER THE SMALL BUSINESS JOB PROTECTION ACT OF 1996** published in the Employee Plans EP/EO CPE Technical Topics for 1997, Article No. 7, page 443.

## **2. SECTION 457(b) "ELIGIBLE" DEFERRED COMPENSATION PLANS.**

Section 457(a) of the Code permits a participant to defer compensation to a deferred compensation plan of an "eligible employer," provided that the plan satisfies the eligibility requirements of section 457. Under section 457(a), compensation deferred pursuant to an eligible plan and the income attributable to such deferred compensation, are taxable in the year in which the deferred amounts are paid or made available to a plan participant or other beneficiary.

### **A. Eligible Employers.**

An eligible deferred compensation plan is defined as any plan, agreement or other arrangement that is established and maintained by an "eligible employer". Sections 457(b), 457(f)(3)(A). The term eligible employer is defined as a State (including the District of Columbia), political subdivision of a State, any agency or instrumentality of a State or political subdivision of a State, and any other organization (other than a government unit) exempt from tax under subtitle A of the Code. Section 457(e)(1), Section 1.457-2(c) of the Regulations. Section 457 therefore applies to all tax-exempt employers that maintain a deferred compensation plan, except churches, which are specifically excluded under section 457(e)(13). The application of section 457 to deferred compensation plans of exempt organizations became effective under the Tax Reform Act of 1986 ("TRA '86"). Deferred compensation plans of agencies and instrumentalities of the Federal Government are not subject to Section 457.

### **B. Who may participate in an Eligible Plan under Section 457(b)(1)?**

#### **(1) In General**

Only individuals who perform services for the entity, either as employees or independent contractors, may be participants in a section 457 plan. Section 457(e)(2), 1.457-2(d). Corporations cannot be participants in a plan.

## **(2) Select Group of Employees of Non-governmental Tax-exempt Entities.**

While any employee or independent contractor of a governmental entity can be a participant, tax-exempt organizations that are non-governmental must limit participation to management and highly compensated employees. This is because of the rules under Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"), which are under the jurisdiction of the Department of Labor.

ERISA generally requires that a plan providing retirement benefits to employees must be funded by an irrevocable trust. Section 457 plans also provide such benefits. However, the rules of section 457 require that such plans be unfunded in order to obtain tax benefits. Therefore, an entity cannot attain tax deferral for its employees under a section 457 plan unless an exception to the funding requirement applies. Government plans are expressly exempt from the funding requirements of ERISA. Other tax-exempt employers may maintain section 457 plans, but only for management and highly compensated employees, as the funding rules under ERISA do not apply to a "top hat" plan, a type of plan which specifically covers these types of employees. If the covered employees do not fall into these exceptions, the plans must be funded plans subject to the rules of ERISA.

Section 457 plans are not subject to the nondiscrimination rules with which funded, qualified plans must comply. These rules are designed to insure that the highly compensated employees of an employer do not receive a disproportionate share of the benefits under qualified plans maintained by the employer. Neither the ERISA coverage rules nor the Code's coverage and nondiscrimination rules apply to unfunded top-hat plans, and no discrimination issue is raised by eliminating all rank and file employees from coverage under eligible 457 plans. In fact, section 457 plans of tax-exempt employers must do just that in order to be eligible plans. In contrast, qualified plans are developed for the rank and file as well as for highly compensated employees.

## **C. Maximum Deferral Limitations under Sections 457(b)(2) and (3); Coordination Limitation under Section 457(c)(2).**

### **(1) General Rule; Cost-of-Living Adjustment.**

Under section 457(b)(2), a plan must provide that the annual amount that can be deferred is limited to the lesser of \$7,500, or 33 1/3 % of a participant's "includible compensation". The \$7,500 limit includes both employer contributions and employee salary reduction deferrals.

The SBJPA added section 457(e)(15) which provides for **A COST-OF-LIVING ADJUSTMENT** (in \$500 increments) of the maximum deferral amounts of \$7,500 under sections 457(b)(2) AND (c)(1) at the same time and in the same manner as under section 401(d), except that the base period is the calendar quarter ending September 30, 1994 and any increase which is not a multiple of \$500 is rounded to the next lowest multiple of \$500. The amendment

is for taxable years beginning after December 31, 1996. For 1998, 1999, and 2000 the deferral rate is \$8,000. The maximum deferral amount for each year is announced before the beginning of the year at the same time as cost-of-living adjustments under section 415(d), by the Employee Plans Division of the Commissioner's office.

The cost-of-living adjustment applies to the Coordination Limitation deferral amount referred to in section 457(c)(1).

The cost-of-living adjustment does NOT apply to the \$15,000 catch-up limitation of section 457(b)(3), and any increase in the amount deferred under section 457(b)(2) will decrease the amount available under the catch-up permitted by section 457(b)(3).

## **(2) "Includible Compensation".**

"Includible Compensation" for a taxable year includes only compensation attributable to services performed for the employer which is currently included in the participant's gross income for the taxable year. Amounts deferred (or otherwise not currently included in gross income) under section 457 and other provisions of the Code are not part of "includible compensation." Section 457(e)(5), Section 1.457-2(e)(2) of the Regulations. These other Code sections under which compensation is not includible in gross income include section 401(k) cash or deferred arrangements (CODAs or 401Ks), section 402(h)(1)(B) simplified employee pensions (SEPs) and section 403(b) tax-sheltered annuities (TSAs). The legislative history of section 457 states that in a typical arrangement, the 33 1/3 percent of includible compensation limitation is equal to 25% of the compensation that would have been received but for the salary reduction agreement. The amount of includible compensation is determined without regard to any community property laws. Section 457(e)(7).

## **(3) Example.**

The following brief example illustrates how the deferral limitation operates to limit the amount of includible compensation that may be deferred under section 457(b). An employee who is scheduled to receive \$24,000 during a taxable year could enter into a salary reduction agreement and elect to defer \$6,000 for that year and be within the deferral limitation under 457(b), because this amount is equal to 25 percent of the employee's gross compensation of \$24,000 and 33 1/3 percent of his or her includible compensation of \$18,000 (\$24,000 - \$6,000).

## **(4) Catch-up Rule.**

An exception to the general deferral limitation under section 457(b)(2) does exist, however. Under section 457(b)(3), an eligible plan may provide that for one or more of a participant's last three taxable years ending before the attainment of retirement age, the amount which may be deferred is increased to the lesser of (A) \$15,000, or (B) the sum of (i) the plan ceiling for purposes of 457(b)(2), plus (ii) so much of the plan ceiling established for purposes of

457(b)(2) for taxable years before the taxable year as has not previously been used under 457(b)(2) or 457(b)(3). (Catch-up Limitation).

With respect to the underutilized limitations and the limited catch-up rule, section 1.457-2(f)(2) of the Regulations provides, in part, that a prior year is taken into account only if (A) it begins after December 1, 1978, (B) the participant was eligible to participate in the plan during all or a portion of the taxable year, and (C) compensation deferred (if any) under the plan during the taxable year was subject to the plan ceiling established under 1.457-2(e)(1).

Section 1.457-2(f)(3) of the Regulations requires that the plan may not permit a participant to elect to have the limited catch-up provision apply more than once, whether or not the limited catch-up is utilized in less than all of the three taxable years ending before the participant attains normal retirement age, and whether or not the participant or former participant rejoins or participates in another eligible plan after retirement. An example found in the regulations points out that if the participant elects to utilize the limited catch-up for only one taxable year before normal retirement age, and after retirement at that age the participant renders services for the State as an independent contractor or otherwise, the plan may not permit the participant to utilize that limited catch-up for any taxable years subsequent to retirement.

When reviewing whether the catch-up limitation is in compliance with section 457(b)(3), remember that "normal retirement age" used to determine the catch-up period may or may not correspond with the time when a participant actually retires. In addition, the third year of the catch-up limitation may not be the actual year of retirement (if chosen by a participant as their normal retirement age), because the third year must be in a year ending before a participant attains normal retirement age.

The cost-of-living adjustment under section 457(e)(15) does not apply to the \$15,000 catch-up limitation of section 457(b)(3), and any increase in the amount deferred under section 457(b)(2) will decrease the amount available under the catch-up permitted by section 457(b)(3). Thus, although the deferral limitation for 1998 has increased to \$8,000, the catch-up permitted in 1998 has not increased to \$15,500, but remains at \$15,000. In future years, as the amount that can be deferred under 457(b)(2) increases, the use of the catch-up limitation will become of less and less benefit to participants under section 457(b) plans. However, because participants may benefit from larger deferral limitations under section 457(b)(2) in future years (due to cost-of-living increases), the benefit of the catch-up may become less important.

#### **(5) Normal Retirement Age.**

Section 1.457-2(f)(4) of the Regulations provides that a plan may define normal retirement age as any range of ages ending no later than age 70 1/2 and beginning no earlier than the earliest age at which a participant has the right to retire under the plan. If no normal retirement age is specified in the plan, then the normal retirement age is the later of the latest retirement age specified in the basic pension plan of the employer, or age 65. Where participants

work past normal retirement age, the plan, within limits, may permit them to designate another normal retirement age.

#### **(6) Coordination Limitation.**

Under Section 457(c)(2), amounts excluded from income under certain types of plans must be treated as amounts deferred under section 457, and therefore counted against the \$7,500 annual limitation, or the 457(b)(3) \$15,000 catch-up limitation. These plans are other section 457 plans, section 401(k) cash or deferred arrangements (CODAs), section 402(h)(1)(B) simplified employee pensions (SEPs), section 403(b) tax-sheltered annuities (TSAs), and plans for which a deduction is allowed because of a contribution to an organization described in section 501(c)(18).

Generally, the effect of section 457(c)(2) is that an individual who defers compensation in both an eligible section 457 plan and in another plan such as a CODA, SEP, or TSA is limited to a total combined deferral of \$8,000 annually [for 1998] if the individual is to enjoy tax deferral on the combined amounts. If the combined deferral exceeds this amount, the amounts treated as excess in the eligible section 457 plan are taxable currently under section 457. However, an individual who, although eligible, does not defer any compensation under the 457 plan in any given year, is not subject to the \$8,000 annual limit [for 1998] of section 457(c)(2), even though the individual defers compensation under one of the other coordinated plans. The coordination limitation applies to plans of all employers rather than being an employer by employer limitation.

Section 457(c)(2) works as follows. Suppose that individual A participates in both an eligible section 457 plan and a section 401(k) arrangement. A defers the maximum amount of \$8,000 under the section 457 plan and \$2,000 under the 401(k) arrangement in 1998, for a total of \$10,000. A will have an excess deferral of \$2,000 under the 457 plan because of section 457(c)(2). The \$2,000 deferred under the 401(k) plan will be applied first against the \$8,000 limit of section 457, and the amount deferred under the section 457 plan, \$8,000, will then be applied and will exceed the \$8,000 limit by \$2,000.

The cost of living increase of section 457(e)(15) applies to the section 457(c)(2) requirements.

Some recent examinations of section 403(b) and eligible section 457(b) plans of the same employer have uncovered problems in the way plans are administering the applicable coordinated deferral limitations.

#### **(7) Plans with delayed vesting provisions.**

Another issue raised by the limitation requirement is found in plans with benefits that vest on a delayed basis. If the compensation deferred is subject to a substantial risk of forfeiture, then compensation deferred is taken into account at its present value in the plan year in which the compensation is no longer subject to a substantial risk of forfeiture. 1.457-2(e)(3) of the

Regulations. Therefore, amounts deferred under an eligible plan over several years subject to a delayed vesting schedule will be combined for purposes of the maximum deferral limit in the year the amounts vest, i.e., are no longer subject to a substantial risk of forfeiture.

**For example**, if an employer sets aside \$3000 per year for five years for a certain employee, and the employee's rights to these amounts vests only in year 5, the employee will be treated as having deferred \$15,000 (\$3000 x 5 years) in year 5, when the amounts vest. Because the employee may only defer **\$8,000** in year 5 under section 457(b), the aggregate of the amounts deferred, \$15,000, is in excess of the limitation by **\$7,000**.

#### **(8) Present Value Requirement.**

Section 457(e)(6) requires that compensation deferred under a plan be taken into account at its present value in the plan year in which deferred. Thus, for example, an employer cannot use unreasonable actuarial assumptions or interest rates to calculate the present value of benefits or the increase in benefits for a defined benefit plan.

#### **(9) Conclusion.**

In summary, whether a plan meets the requirements of section 457(b) and (c) of the Code will require a review of (1) whether the amounts being deferred under the plan are within the eligible plan limitations, (2) whether any of these amounts are subject to a substantial risk of forfeiture, and (3) whether the employees are participating in another plan requiring a coordination of benefits under section 457(c)(2). A pattern of continuous excess deferrals or other inconsistencies will require a further examination into whether the plan is being administered in compliance with section 457 of the Code.

### **D. FUNDING REQUIREMENTS**

#### **(1) Generally.**

##### **New Requirements for Eligibility under the SBJPA**

Starting on January 1, 1997, important statutory changes to section 457 resulting from the passage of the SBJPA affect all eligible section 457(b) plans of state and local government employers. In particular, new section 457(g) now requires that all amounts deferred under eligible section 457(b) plans of state and local government employers be set aside in trust for the exclusive benefit of plan participants. This is in direct contrast to the law prior to the enactment of the SBJPA, which as pointed out below, still subjects eligible section 457(b) plans of tax-exempt employers to section 457(b)(6) of the Code, and therefore still requires that they be unfunded. The discussion below highlights the different eligibility requirements for plans of tax-exempt employers compared to plans of state and local government employers.

When reviewing section 457 plans after January 1, 1997, it is now important to note what kind of employer is sponsoring the plan. If it is a tax-exempt employer, the plan must be unfunded and subject to all of the requirements listed under section 457(b)(6). If the plan is sponsored by a governmental entity, look at whether it is a newly adopted plan or one already in existence on August 20, 1996. For plans adopted after August 20, 1996, the funding requirements of section 457(g) apply immediately. For governmental plans already in existence on August 20, 1996, a trust need not be established before January 1, 1999. A governmental employer may, however, establish a trust before that date, if it wishes to do so. Until January 1, 1999 or such time that a trust is created, however, the law in effect prior to the enactment of the SBJPA, (that is, section 457(b)(6)), applies to governmental plans that were in existence on August 20, 1996.

**(2) Plans of Tax-Exempt Employers must be Unfunded under Section 457(b)(6).**

Another key requirement of eligibility for tax-exempt employers (and for existing government employers prior to January 1, 1997, or later, if the governmental plan is only amended at some date before December 31, 1998) is articulated in section 457(b)(6), which continues to mandate that a section 457 plan be unfunded and that plan assets not be set aside for participants. Section 457(b)(6) states that an eligible plan must provide that:

(A) all amounts of compensation under the plan, (B) all property and rights purchased with such amounts, and (C) all income attributable to such amounts, property or rights, shall remain (until made available to the participant or beneficiary) solely the property and rights of the employer (without being restricted to the provision of benefits under the plan) subject only to the claims of the employer's general creditors.

This is true whether the funds deferred originate with the employee or the employer. Therefore, amounts credited to an employee's section 457 account are legally considered to be funds belonging to the tax-exempt employer (or governmental employer under an existing plan until it is amended by the governmental employer to comply with the new section 457(g)) until such amounts have been paid or made available to the employee. Any funding arrangement under an eligible section 457(b) plan of a tax-exempt employer that sets aside assets for the exclusive benefit of participants is in violation of section 457 and will trigger immediate taxation under sections 402(b) and 83 of the Code. Any language in a plan that either contradicts or appears to contradict this requirement should result in a thorough review of the plan document. Section 457 plans may use a so-called "rabbi" trust arrangement, however, without violating this requirement.



### **(3) Governmental Plans Must Maintain Set-Asides for the Exclusive Benefit of Plan Participants under Section 457(g).**

Section 457 has been amended by adding a new section 457(g) which states in paragraph (1) that in order for a GOVERNMENT PLAN to be an eligible plan, all assets and income of the plan described in section 457(b)(6) must be held in TRUST for the EXCLUSIVE BENEFIT OF PARTICIPANTS AND THEIR BENEFICIARIES. **IT IS IMPORTANT TO REMEMBER (as discussed in paragraph (2) above) THAT THE RULES FOR TAX-EXEMPT PLANS UNDER SECTION 457(b)(6) HAVE NOT CHANGED.**

Section 457(g)(2) provides generally that: A) a trust described in paragraph (1) shall be treated as an organization exempt from tax under section 501(a), and B) notwithstanding any other provision of the Code, amounts in the trust shall be includible in the gross income of the participants and beneficiaries only to the extent, and at the time, provided for in section 457.

Section 457(g)(3) provides that custodial accounts and contracts described in section 401(f) (annuity contracts) are to be treated as trusts under rules similar to those under section 401(f).

For new eligible section 457(b) plans of government employers, the effective date for this section is August 20, 1996 (the date of the enactment of the SBJPA). For government plans in existence on August 20, 1996, a trust need not be established before January 1, 1999.

The effect of this new law is that amounts credited to an employee's section 457 account must be set aside in trust for the exclusive benefit of that employee, and are not available to the employer's creditors, even before such time that the amounts are paid or made available to the employee. This is the exact opposite of the effect of the unfunded requirement that still exists for eligible section 457(b) plans of tax-exempt employers. The new law is intended to provide improved security to government employees who participate in these plans.

### **(4) Guidance under Notice 98-8.**

#### **(a) Trust Requirement**

Notice 98-8 provides guidelines for satisfying the trust requirement of section 457(g). To satisfy the trust requirement applicable to governmental ' 457(b) plans under section 457(g)(1), a trust must be established pursuant to a written agreement that constitutes a valid trust under state law. The terms of the trust must make it impossible, prior to the satisfaction of all liabilities with respect to plan participants and their beneficiaries, for any part of the assets and income of the trust to be used for, or diverted to, purposes other than for the exclusive benefit of plan participants and their beneficiaries.

In order to satisfy the requirement that all plan assets and income be held in trust, amounts deferred under a governmental section 457(b) plan after a trust has been established must be transferred to the trust within a period that is not longer than is reasonable for the proper administration of the accounts of participants. For purposes of this requirement, a governmental section 457(b) plan may provide for amounts deferred for a participant under the plan to be transferred to the trust within a specified period after the date the amounts would otherwise have been paid to the participant. For example, a governmental section 457(b) plan could provide for amounts deferred under the plan to be contributed to the trust within 15 business days following the month in which these amounts would otherwise have been paid to the participant. See section 2510.3-102(b) of the Department of Labor regulations concerning contributions to an employee pension plan that is subject to the Employee Retirement Income Security Act ("ERISA") (such as a plan qualifying under ' 401(k) of the Code). However, a governmental section 457(b) plan is not subject to ERISA, and, thus, is not subject to the Department of Labor regulations.

The Notice points out that unless all assets or income of a plan are held in one or more trusts that satisfy the requirements of section VI of Notice 98-8 (or in custodial accounts or annuity contracts that are treated as trusts under section VII of Notice 98-8), the plan is not a section 457(b) plan because the requirements of section 457(g) are not met.

**(b) Custodial Accounts and Annuity Contracts treated as Trusts under Section 457(g)(3)**

Section 457(g)(3) provides that, for purposes of the section 457(g)(1) trust requirements, custodial accounts and annuity contracts described in section 401(f) will be treated as trusts under rules similar to the rules under section 401(f). Section 1.401(f)-1(b) of the regulations contains requirements that a custodial account or an annuity contract must satisfy to be treated as a trust. For purposes of applying the section 401(f) rules under section 457(g), the requirements under section 1.401(f)-1(b) of the regulations generally will be used to determine whether a custodial account or annuity contract meets the requirements of section 457(g)(3).

Specifically, the Notice provides that a custodial account will be treated as a trust, for purposes of section 457(g)(1), if the custodian is a bank, as described in section 408(n), or a person who meets the nonbank trustee requirements of section VIII of Notice 98-8, and the account meets the requirements of section VI of Notice 98-8, other than the requirement that it be a trust.

An annuity contract will be treated as a trust under section 457(g)(1) if the contract is an annuity contract, as defined in section 401(g), that has been issued by an insurance company qualified to do business in the state, and the contract meets the requirements of section VI of Notice 98-8, other than the requirement that it be a trust. An annuity contract does not include a life, health or accident, property, casualty, or liability insurance contract.

The use of a custodial account or annuity contract as part of a governmental section 457(b) plan does not preclude the use of a trust or another custodial account or annuity contract as part of the same governmental section 457(b) plan, provided that all such vehicles satisfy the requirements of section 457(g)(1) and (3) and all assets and income of the plan are held in such vehicles. Unless all assets and income of a plan are held in one or more trusts, custodial accounts, or annuity contracts that satisfy section VI or VII of Notice 98-8, the plan is not an eligible section 457(b) plan because the requirements of section 457(g) are not met.

**Nonbank Trustee Status.** The custodian of a custodial account may be a person other than a bank only if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer the custodial account will be consistent with the requirements of sections 457(g)(1) and (g)(3). To do so, the person must demonstrate that the requirements of paragraphs (2)-(6) of section 1.408-2(e) of the regulations relating to Nonbank Trustees will be met. The written application must be sent to the address prescribed by the Commissioner in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin in the same manner as prescribed under section 1.408-2(e) of the regulations.

To the extent that a person has already demonstrated to the satisfaction of the Commissioner that the person satisfies the requirements of ' 1.408-2(e) of the regulations in connection with a qualified trust (or custodial account or annuity contract) under ' 401(a), that person will be deemed to satisfy the requirements of section VIII of Notice 98-8.

## **E. Timing of Elections/Constructive Receipt Issues.**

### **(1) Constructive receipt.**

The tax consequences of nonqualified deferred compensation plans are governed by the constructive receipt doctrine embodied in the regulations under section 451 of the Code, and, in the case of state and local government and tax-exempt entities, by section 457.

Section 451(a) of the Code and section 1.451-1(a) of the regulations provide that under the cash receipts and disbursements method of accounting, an item of gross income is includible in gross income for the taxable year in which the taxpayer actually or constructively receives it. Section 1.451-2(a) of the regulations provides that income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart for him, or otherwise made available so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

### **(2) Elections under section 457.**

A section 457 plan must provide that compensation for any month may be deferred only if the agreement providing for the deferral is entered into before the beginning of that month. However, with respect to a new employee, a plan may provide that compensation may be

deferred for the calendar month during which that participant first becomes an employee, if an agreement providing for the deferral is entered into on or before the first day on which the participant becomes an employee. Sections 457(b)(4), 1.457-2(g).

Generally, a participant or beneficiary may elect the manner in which the deferred amounts will be distributed. Moreover, amounts deferred under an eligible section 457 plan will not be considered made available solely because the participant is permitted to choose among various investment modes under the plan for the investment of such amounts, whether before or after payments have begun under the plan. While the employer can give the participant a choice of investment methods, the employer is not required to do so.

Section 1.457-1(b) of the regulations states, in part, that for purposes of section 457(a) of the Code, amounts deferred under an eligible plan will not be considered made available if, under the plan, the participant may irrevocably elect prior to the time these amounts become payable (under the distribution provisions of the plan) to defer the payment of some or all of these amounts to a fixed and determinable future time. In order for the Service, as well as plan participants (or their beneficiaries) to ascertain when deferred amounts become payable, an eligible plan must specify a fixed or determinable time of payment by reference to the occurrence of an event (for example, retirement) that triggers the individual's right to receive or begin to receive the amounts deferred under the plan.

Prior to the changes made by the SBJPA (discussed below in (E)(3)), a participant could not change his or her deferral election.

### **(3) New Additional Deferral Election.**

Section 457(e)(9)(B), which was added to section 457 under the SBJPA, increases the number of elections that can be made by a participant with respect to the time that distributions must begin under the plan, subject to certain requirements. Section 457(e)(9)(B) provides that the total amount payable to a participant under the plan will not be treated as made available to the participant if the participant is given an additional opportunity to elect to defer commencement of distributions under the plan if (i) such election is made after amounts may be made available under the plan in accordance with the distribution requirements under section 457(d)(1)(A) and before commencement of such distribution, and (ii) the participant makes only one such (additional) election. The amendment is effective for taxable years beginning after December 31, 1996.

Employers have the option as to whether to add this new provision to their eligible section 457(b) plans.

Notice 98-8 provides guidance on how this new election operates. Under section 457(d)(1)(A), benefits under a ' 457(b) plan generally may not be made available to a participant before the participant separates from service with the employer. Prior to the addition of this new

in-service distribution, in-service distributions were permitted only if the participant had an unforeseeable emergency or attained age 70 1/2.

As stated above, section 1.457-1(b) of the regulations provides that amounts are not made available if a participant irrevocably elects, prior to the time the amounts become payable, to defer the payment to a fixed and determinable future time. For purposes of the Notice, the time at which amounts become payable is referred to as the "first permissible payout date" and is the earliest date on which a plan permits payments to begin after separation from service (i.e., disregarding payments to a participant who has an unforeseeable emergency or attains age 70 1/2, or under the in-service distribution provision described in section III of Notice 98-8).

Section 457(e)(9)(B), as amended by the SBJPA, provides that the amount payable to a participant under a ' 457(b) plan is not treated as made available merely because the plan allows the participant to make an additional election, after the first permissible payout date, to defer the commencement of distributions, so long as this additional deferral election is made before distributions begin (a "' 457(e)(9)(B) additional deferral election"). Only one ' 457(e)(9)(B) additional deferral election can be made after the end of the period in which the plan permits a participant to make deferral elections under ' 457(d)(1)(A) and ' 1.457-1(b) of the regulations.

A participant is not precluded from making a ' 457(e)(9)(B) additional deferral election merely because the participant has previously received a hardship distribution under ' 457(d)(1)(A) or has made other deferral elections prior to separation from service.

The ' 457(e)(9)(B) additional deferral election is not available if the participant has separated from service and distributions have begun. The ' 457(e)(9)(B) additional deferral election permits the participant to elect only to defer, and not to accelerate, commencement of distributions under the plan.

The ' 457(e)(9)(B) additional deferral election provision is illustrated in Notice 98-8 by the following examples:

Example (1). (i) Employee A is a participant in an eligible ' 457(b) plan. The plan provides that the total amount deferred under the plan is payable to a participant who separates from service before age 65. Payment is made in a lump sum 90 days after separation from service, unless, during a 30-day "window period" immediately following the separation, the participant elects to receive the payment at a later date or in 10 annual installments to begin 90 days after separation from service or at a later date. The plan also permits eligible participants to make a ' 457(e)(9)(B) additional deferral election. Employee A separates from service at age 50. The next day, during the 30-day window period provided in the plan, Employee A elects to receive distribution in the form of 10 annual installment payments beginning at age 55. Two weeks later, within the 30-day window period, Employee A makes a new election permitted under the plan to receive 10 annual installment payments beginning at age 60 (instead of at age 55).

(ii) In this example, the two elections Employee A makes during the 30-day window period are not ' 457(e)(9)(B) additional deferral elections (because they are made before the first permissible payout date under the plan) and therefore do not preclude the plan from allowing Employee A to make a ' 457(e)(9)(B) additional deferral election after Employee A's election to receive 10 annual installment payments beginning at age 60.

Example (2). (i) The facts are the same as in Example (1). Employee A has made no other deferral elections after the 30-day window period and before age 59. While age 59, Employee A elects to defer commencement of the installment payments until Employee A attains age 65.

(ii) In this example, under ' 457(e)(9)(B), the total amount payable to Employee A will not be treated as made available merely because Employee A made this additional election at age 59 (after the first permissible payout date under the plan, but before commencement of distributions). However, after making this election, Employee A may make no further elections to change the date on which distributions commence.

We recently received an inquiry on whether the additional deferral election under section 457(e)(9)(B) also provides a participant with the opportunity to select a new payout period or option. The simple answer is no. Thus, for example, under the facts of Example 2 of Notice 98-8 described above, when Employee A elects to defer commencement of his payment until Employee A attains age 65, Employee A could not also elect to change his payout from 10 annual installments to a lump sum distribution at age 65.

Finally, section 1.457-1(b)(1) of the Regulations and the examples that follow provide some guidance as to when amounts deferred will or will not be considered to have been made available to the participant or beneficiary, absent the new election permitted by the SBJPA. Prior to the addition of section 457(e)(9)(B) by the SBJPA, the regulations provided that a participant could not change the election he or she made once a participant was otherwise eligible to receive a distribution under the plan.

### **(3) Restriction on distributions and constructive receipt.**

A participant in a section 457 plan may not withdraw the deferred amounts at any time prior to the occurrence of a payout event set out in section 457(d)(1)(A). (See section F below on Permitted Distributions.) Under section 457 of the Code and the regulations thereunder, and under the long established doctrine of constructive receipt of income (codified in section 451), if a plan participant were able to receive his deferred compensation at any time without restriction after he retired, he would be in constructive receipt of any amounts subject to being withdrawn in the taxable year of his retirement, even though these amounts were not actually paid. Under section 457(a) of the Code, the participant's ability to control the time when he would receive these amounts would make the deferred amounts available to him and includible in gross income

for the year in which he retired, or if already retired, in the current taxable year.

**F. Permitted Distributions under 457(d)(1).**

**(1) Generally.**

Section 457(b)(5) provides that an eligible section 457 plan must meet the distribution requirements of section 457(d). Section 457(d)(1) provides that the plan must require that the amounts deferred under the plan will not be made available to participants or beneficiaries earlier than (i) the calendar year in which the participant attains age 70 1/2, (ii) when the participant is separated from service with the employer, or (iii) when the participant is faced with an unforeseeable emergency, determined in the manner prescribed by the Secretary in regulations. The first option (age 70 1/2) requires no further explanation. This section discusses separation from service, unforeseeable emergencies, and a series of other issues related to when distributions may be made. The next section discusses when distributions must be made.

**(2) Separation from Service.**

**a. Generally.**

A participant's separation from service with the employer is an event which may give rise to the distribution of amounts from the plan to the employee.

**b. What constitutes separation from service.**

Under the regulations, an employee is separated from service with the State if there is a separation from service within the meaning of section 402(d)(4)(A)(iii) (formerly section 402(e)(4)(A)(iii)), relating to lump sum distributions. Generally, an employee is not separated from service where the participant continues the same job in the same work environment with a different employer as a result of a merger, liquidation or other similar circumstances and the new employer continues the plan (the so-called "same desk" rule). An employee is generally considered to be separated from service if the employee's job duties with the new employer are substantially different from the job duties performed for the old employer. A distribution is also considered to be made due to separation from service if it is made on account of the participant's death or retirement. Section 1.457-2(h)(2).

**c. Special rules for Independent Contractors.**

Separation from service with respect to an independent contractor is discussed in section 1.457-2(h)(3) of the regulations, which provides that:

an independent contractor is considered separated from service with the State upon the expiration of the contract or in the case of more than one contract, all contracts under

which services are performed for the State, if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration will not constitute a good faith and complete termination of the contractual relationship if the State anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, a State is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to again contract for the services provided under the expired contract, and neither the State nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, a State is considered to intend to again contract for the services provided under an expired contract, if the State's doing so is conditioned only upon the State's incurring a need for the services, or the availability of funds, or both.

The regulations go on to set out a safe harbor rule providing that no amounts payable under a plan will be considered to be paid or made available to the participant before the participant separates from service with the State if the plan provides that:

- (A) No amount shall be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the State (or in the case of more than one contract, all such contracts expire), and
- (B) No amount payable to the participant on that date shall be paid to the participant if, after the expiration of the Contract (or contracts) and before that date, the participant performs services for the State as an independent contractor or an employee.

Be careful to examine whether there has been an actual separation from service and not just an insignificant change in the nature of the services performed. For example, contracts between doctors and state or tax-exempt hospitals may deem there to have been a separation from service where the nature of the services performed has changed somewhat, but in fact the doctor has never left the service of the hospital. On the other hand, you also need to keep in mind the question of whether the participant's duties or status have been reduced to such a point that there has been a "constructive termination". Look beyond the contract involved to the individual facts of each situation.

### **(3) Unforeseeable Emergencies.**

There is one exception to the general rule prohibiting in-service withdrawals. The plan may permit a participant to accelerate the payment of an amount remaining payable in the event of an "unforeseeable emergency," as defined in section 1.457-2(h)(4) of the regulations. A Plan does not have to provide for emergency withdrawals and eliminating such a provision does not raise any protected benefit issues akin to those applicable to qualified plans under section 411(d)(6). However, benefits would not be considered made available merely because the plan contained such a provision. IT IS IMPORTANT TO REALIZE THAT A WITHDRAWAL FOR



AN 'UNFORESEEABLE EMERGENCY' IS MORE DIFFICULT TO OBTAIN AND DIFFERS SUBSTANTIALLY FROM A 'HARDSHIP WITHDRAWAL' UNDER A SECTION 401K PLAN.

Section 1.457-2(h)(4) defines "unforeseeable emergency" as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant or of a dependent of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The circumstances that will constitute an unforeseeable emergency will depend on the facts of each case, but in any case, payment may not be made to the extent that such hardship is or may be relieved: (i) through reimbursement or compensation by insurance or otherwise, (ii) by liquidation of the participant's assets, to the extent the liquidation of the assets would not itself cause severe financial hardship, or (iii) by cessation of deferrals under the Plan. Examples of what are not considered to be unforeseeable emergencies include the need to send a child to college or the desire to purchase a home. Withdrawals of amounts because of an unforeseeable emergency must only be permitted to the extent reasonably required to satisfy the emergency need.

Any plan that has a large number of hardship withdrawals should be reviewed to determine whether the withdrawals are being administered in compliance with the hardship regulations. If the plan permits an employee to withdraw amounts virtually at will, this is a clear violation of the rules.

#### **(4) Loans.**

Unlike the statutory scheme for qualified employer plans, which are authorized to make loans that will not be treated as plan distributions in certain circumstances, loans from or against section 457 plan assets are not authorized by statute. Under the SBJPA, however, there is some legislative history which implies that amounts held in trust may be loaned to participants in plans of state and local government employers. The making of loans is currently under consideration and advice should be sought before addressing loans as a possible defect when examining an eligible section 457(b) plan of a state or local government employer.

Loans from or against assets of unfunded eligible section 457(b) plans of tax-exempt employers are still NOT permitted.

#### **(5) Offsets.**

To the extent an eligible section 457(b) plan of a tax-exempt employer does not contain anti-alienation language and does contain a provision permitting the employer to offset an employee's interest in a plan against amounts owed to the employer, an issue arises as to whether an offset provides the participant with a right to assign an interest in plan assets in violation of section 457(b)(6). Section 457(b)(6) requires that all amounts deferred under the Plan, all

property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights will remain (until made available to the participant or beneficiary) solely the property and rights of the (tax-exempt) Employer, subject only to the claims of the Employer's general creditors.

Another issue raised by an offset is whether an employee has received an economic benefit equal to the amount of the offset, thus causing current taxation of that amount under the cash equivalency theory. See Cowden v. Commissioner, 32 T.C. 853 (1959), rev'd and rem'd, 289 F.2d 20 (5th Cir. 1961), on remand, 20 T.C.M. 1134 (1961).

Any questions on this issue should be forwarded to Counsel.

#### **(6) Transfers and Rollovers.**

Unlike the situation under a qualified plan, a participant who receives a distribution under a section 457 plan cannot further defer the funds tax free. The sole exception is transfers of the funds to another eligible 457 deferred compensation plan as is permitted under section 457(e)(10) of the Code and section 1.457-2(k) of the regulations. Under section 457(e)(10), a participant is not required to include in gross income any amount payable to the participant just because there is a transfer of funds from one eligible deferred compensation plan to another eligible deferred compensation plan. No similar exception is provided for a rollover or transfer of funds to any other type of plan or arrangement, including an IRA. See Rev. Rul. 86-103, 1986-2 C.B. 62.

#### **(7) In-Service Distributions of \$5,000 or Less.**

Section 457(e)(9)(A) was added to section 457 under the SBJPA. This new section provides that the total amount payable to a participant under the plan will not be treated as made available merely because the participant may elect to receive such amount (or the plan may distribute such amount without the participant's consent) if (i) such amount does not exceed \$3,500, and (ii) such amount may be distributed only if--(I) no amount has been deferred under the plan with respect to such participant during the 2-year period ending on the date of the distribution, and (II) there has been no prior distribution under the plan to such participant under this option. This amendment is effective for taxable years beginning after December 31, 1996.

The conference report under the SBJPA makes clear that this provision applies to accounts that do not exceed \$3,500 (and, therefore, not to all distributions of amounts of less than \$3,500, even though they may be from accounts which have higher account balances.) Section 457(e)(9)(A) is an optional provision for employers who sponsor eligible section 457(b) plans.

The specified dollar amount under 457(e)(9)(A) was changed from \$3,500 to \$5,000, effective for plan years beginning after August 5, 1997, by ' 1071(a) of the TRA '97. Each participant can be given only one such in-service distribution from the plan. This in-service distribution is available only if no amount has been deferred under the section 457(b) plan for the

participant during the 2-year period ending on the date of the distribution.

Notice 98-8 provides several alternative ways this provision can operate under a plan. For example, a section 457(b) plan may provide for the total amount payable to a participant with a balance of \$5,000 or less to be distributed to the participant if the participant so elects. Alternatively, the plan may provide for the total amount payable to a participant with a balance of \$5,000 or less to be distributed automatically to the participant. A section 457(b) plan is permitted to substitute a specified dollar amount that is less than \$5,000 under either of these alternatives. In addition, these two alternatives can be combined; for example, a plan could provide for automatic cashout for balances up to \$500 and allow participants to elect a cashout for balances above \$500 but not above \$5,000.

Finally, a section 457(b) plan is not required to permit in-service distributions under any of these alternatives.

#### **(8) Penalty and Excise taxes.**

The 10% penalty tax of section 72(t) on early distributions from a tax-qualified plan, IRA or tax sheltered annuity does **not** apply to section 457. Neither does the 15% excise tax on excess distributions from these kinds of plans under section 4980A.

### **G. Minimum Distribution Requirements of 457(d)(2).**

#### **(1) In General.**

Section 1107 of the Tax Reform Act of 1986 added the minimum distribution requirements of 457(d)(2) in order to ensure that the tax-favored savings provided through section 457 are used primarily for retirement purposes. In general, the provisions are similar but not identical to those that apply to qualified plans and to arrangements under section 403(b) of the Code.

#### **(2) Statutory Provisions.**

Section 457(d)(2)(A) provides that a plan meets the minimum distribution requirements for purposes of section 457 if the plan meets the minimum distribution requirements of section 401(a)(9). The general rule under section 401(a)(9) requires that a participant begin distribution of certain amounts under a plan not later than April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2. In the case of a government plan, and now in the case of a tax-exempt organization for years beginning on or after January 1, 1997, if the plan so provides, the required beginning date is the LATER of the general rule stated above or April 1 of the calendar year following the calendar year in which the employee retires.

Section 457(d)(2)(B) of the Code provides that in the case of a distribution beginning before the death of the participant, the plan must provide that the distribution will be made in a form under which the amounts payable with respect to the participant will be paid at times specified by the Secretary, which are not later than the time determined under section 401(a)(9)(G) (relating to incidental death benefits), and that any amounts distributed to the participant during his life will be distributed after the death of the participant at least as rapidly as under the method of distribution being used under the previous rule as of the date of his death. In the case of a distribution which begins after the death of the participant, the entire amount payable with respect to the participant must be paid during a period that does not exceed 15 years, or the life of the surviving spouse, if the spouse is the beneficiary. Finally, the plan must meet the nonincreasing benefit requirement of section 457(d)(2)(C). Both the section 401(a)(9)(G) rule and the nonincreasing benefit requirement are discussed below.

**a. Section 401(a)(9)(G) Rule.**

**(1). Legislative History.**

Prior to being amended by section 1101(e)(10) of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), section 457(d)(2)(B)(i)(I) required that, in the case of a distribution beginning before the death of the participant, the distribution be made in a form under which "at least 2/3 of the total amount payable with respect to the participant will be paid during the life expectancy of such participant (determined as of the commencement of the distribution),..."

As amended by section 1011(e)(10) of TAMRA, the above quoted provision of section 457(d)(2)(B)(i)(I) now requires the distribution to be made in a form under which "the amounts payable with respect to the participant will be made at times specified by the Secretary which are not later than the times determined under section 401(a)(9)(G) (relating to incidental death benefits),..."

The Senate Finance Committee Report accompanying TAMRA explains the above amendments by stating that the Secretary is instructed to "issue tables that implement the incidental death benefit rule [provided in section 457(d)(2)(B)(i)(I)]...that are similar to those applicable under section 401(a)(9) but require more rapid distributions. Generally, the extent to which more rapid distributions are to be required is to be similar to the extent to which the former section 457(d)(2)(B)(i)(I) rule required more rapid distributions than the former version of the incidental benefit rule." These tables have not yet been issued. However, as noted below, the tables applicable to qualified plans may be used pending issuance of section 457 tables.

**(2) Section 401(a)(9) regulations.**

Section 401(a)(9)(G) of the 1986 Code provides for an incidental death benefit rule designed to apply uniformly to the various types of plans designed to qualify under section

401(a). This rule replaces the incidental benefit rule stated in section 1.401-1(b)-1 of the regulations, adopted under the 1954 Code, which requires that a plan qualified under section 401(a) be designed to provide benefits primarily to employees, but may provide for the payment of incidental death benefits by insurance or otherwise.

The minimum distribution tables found in section 1.401(a)(9)-2 of the Proposed Regulations are intended to implement the incidental death benefit rule required under section 401(a)(9)(G) by providing a simple and uniform method of determining the amount of benefits payable to employees during their expected lifetimes.

A section 457 plan now providing an incidental benefit based on the "at least 2/3" requirement may be liberalized to adopt the somewhat less rapid distribution rule provided under the section 1.401(a)(9)-2 table. Bear in mind, however, that if temporary or final regulations issued are more restrictive than the 401(a)(9)(G) tables, the more liberal incidental death benefit rule would be required to be amended once again.

#### **b. Substantially Nonincreasing Amounts.**

One of the distribution requirements, section 457(d)(2)(C), provides that when distributions under an eligible section 457 plan are payable over a period longer than one year, they must be paid in "substantially nonincreasing amounts" and paid not less frequently than annually. The committee reports accompanying the TRA '86 offer no explanation for or discussion of this rule.

The Service has not yet defined what constitutes "substantially nonincreasing amounts." Nor has the Service mandated that complex actuarial computations must support a distribution schedule of "substantially nonincreasing amounts." Until the section 457 regulations are revised with respect to section 457(d)(2)(C), or until Congress legislates a definition of "substantially nonincreasing amounts," the plain meaning of that phrase applies. Under the plain meaning, amounts distributed need not be equal but they also should not be too disparate. For example, the Service might likely conclude that a benefit increase from \$1,750 to \$3,500 a month, or \$21,000 to \$42,000 a year is a substantial increase under the plain meaning of the language, and would be a violation of section 457(d)(2)(C) of the Code.

An increase in the amount distributed each year that reflects earnings on the deferred amounts is acceptable.

For example, we have issued private letter rulings which permit an employer's section 457(b) plan to provide for certain distribution options that include automatic annual cost-of-living adjustments based on an identified and nationally recognized cost-of-living index, without violating this requirement.

In addition, if a plan administrator increased the amount distributed in any given year to a participant to reflect earnings on the amounts deferred by a participant (for example, due to strong stock market returns), such an increase would not violate the "substantially nonincreasing" requirement. This permitted increase in the amount distributed to a participant may also assist a plan administrator when there is an increase in the amount of the minimum required distribution to a participant under section 457(d) and section 401(a)(9), in light of a substantial increase in the amount of earnings in the account.

### **(3) Penalty.**

In the event a participant (or beneficiary) fails to receive, or receives less than, the minimum distribution required, a penalty may be imposed by section 4974(a) of the Code. The penalty amounts to 50% of the difference between the distribution actually received, if any, and the required minimum distribution under section 457(d)(2). This penalty can be waived by the Service under appropriate circumstances such as an inadvertent error or good-faith effort on the part of the participant (or beneficiary) in complying with the requirements.

### **H. Correction Period.**

Under section 457(b)(6) and section 1.457-2(l) of the regulations, a section 457 plan maintained by a government employer which is not administered by the employer in accordance with the requirements of section 457 ceases to be an eligible plan on the first day of the first plan year beginning more than 180 days after the date of written notification by the Internal Revenue Service that the requirements are not satisfied, unless the inconsistency is corrected before the first day of that plan year. This grace period does not, by its terms, apply to the plans of tax-exempt entities. Counsel should be notified if this kind of Notice is contemplated.

### **I. Employment Taxes.**

Sections 3121(v) controls the timing of the payment of FICA taxes for purposes of section 457(b) plans. Section 3121(v)(2) provides, generally, that any amount deferred under a nonqualified deferred compensation plan is to be taken into account for purposes of employment taxes as of **the later of** when the services are performed, or when there is no substantial risk of forfeiture of the rights to such amounts.

Amounts deferred (both elective and nonelective) under eligible plans are generally subject to FICA taxes at the time of deferral (when the services are performed) because at that time the amounts are usually not subject to a substantial risk of forfeiture. The fact that some section 457 plans are unfunded plans and amounts credited under these plans are subject to the claims of the general creditors of the entity does not make the amounts subject to a substantial risk of forfeiture. On the other hand, amounts which are subject to a delayed vesting schedule (see section C.(7) of this article) are generally subject to FICA taxes when they vest under the provisions of the plan.

## **K. 457(b) RULING PROGRAM**

Beginning in late 1996, we suspended, until further notice, the issuance of letter rulings regarding the tax effects of provisions under the SBJPA affecting section 457 plans. See Revenue Procedure 96-56, 1996-2 C.B. 389. With the issuance of Revenue Procedure 98-40, 1998-2 C.B. 134, we resumed ruling on section 457 plans complying with the requirements contained in its sections 3 and 4.

### **3. SECTION 457(f) "INELIGIBLE" DEFERRED COMPENSATION PLANS.**

Section 457(f)(1) of the Code governs the tax treatment of most nonqualified plans that are not eligible deferred compensation plans under section 457(b). However, transfers subject to section 83 are not subject to either set of section 457 rules. Generally, employers use ineligible plans when they want to provide a benefit greater than the \$7,500 limit imposed on eligible section 457(b) plans or when they want to condition that benefit on the employee's future performance of services to the employer, or both. These are often called "golden handcuff" plans.

Section 457(f)(1) does not apply to that portion of any plan consisting of a transfer of property described in section 83 or to that portion of any plan consisting of a trust to which section 402(b) applies.

In general, section 457(f)(1)(A) of the Code provides that the amount of compensation that is deferred under a plan subject to section 457(f)(1) is included in the participant's or beneficiary's gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation.

#### **A. What is a Substantial Risk of Forfeiture?**

Section 457(f)(3)(B) provides that the rights of a person to compensation are subject to a substantial risk of forfeiture if the participant's rights to the amounts deferred are conditioned upon the future performance of substantial services. Section 83 of the Code and the regulations thereunder provide additional assistance in determining what is a substantial risk of forfeiture and what kind of services are substantial for purposes of section 457(f).

Section 1.83-3(c)(1) of the regulations provides that **whether a risk of forfeiture is substantial or not depends upon the facts and circumstances**. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

For example, the regulations point out that requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture. But, if the amounts are forfeited because an employee leaves before rendering two years of service with the employer, a substantial risk of forfeiture will be considered to exist. (See B. below).

For ruling purposes, a risk of forfeiture based upon the employee's death, living to a specified age, or the employer's insolvency, fall short of the section 83 requirement.

### **B. Are the Services Substantial?**

Section 83 also requires that the future services to be performed in connection with the transfer of rights in property be substantial. Section 1.83-3(c)(2) of the regulations provides illustrations of substantial risks of forfeiture and states that "**the regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial.**" The fact that the person performing services has the right to decline to perform such services without forfeiture may tend to establish that services are insubstantial."

Generally, any requirement for the performance or nonperformance of services over a period of less than twenty-four months tends to indicate that the services required are not substantial.

Section 1.83-3(c)(4), Ex.(1) provides, that where a Corporation transfers to an employee 100 shares of stock in the Corporation at \$90 per share, and the employee is obligated to sell the stock to the Corporation at \$90 per share if he terminates his employment with the Corporation for any reason prior to the expiration of a two year period of employment, the employee's rights to the stock are subject to a substantial risk of forfeiture during such two year period. If the conditions on transfer are not satisfied, it is assumed that the forfeiture provision will be enforced. Thus, requiring two years of service before vesting would generally be "substantial" risk.

The regulations provide at least two additional examples where the services performed (or not performed) may not be substantial.

#### **(1) Covenant not to Compete:**

A covenant not to compete or a noncompetition clause which requires an employee not to compete with the employer once the employee separates from service often falls short of the section 83 requirement. Section 1.83-3(c)(2) provides that factors that may be taken into account in determining whether a covenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities,



the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce such covenants. Thus, a requirement that an employee not accept a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary.

## **(2) Incidental Consulting Services:**

A second area mentioned by the regulations is incidental consulting services. The regulations state that rights in property transferred to a retiring employee subject to the sole requirement that the property be returned unless the employee renders consulting services upon the request of the employer will not be considered subject to a substantial risk of forfeiture unless he is in fact required to perform the services. Another question raised in this analysis is whether the services to be performed are substantial or merely incidental. A facts and circumstances analysis is required in order to determine this. The example below provides such an analysis.

### **C. Sample Plan**

The following sample plan exemplifies how difficult it can be to determine whether a substantial risk of forfeiture exists for purposes of section 83 and section 457(f), and why each case necessitates its own facts and circumstances analysis. Under the terms of a section 457(f) plan recently reviewed for ruling purposes, a participant doctor is entitled to receive benefits from a tax-exempt hospital upon the completion of certain employment requirements. Specifically, the doctor is required to 1) review cases and 2) provide consulting with regard to a department of the hospital. The Plan states that the doctor will be entitled to benefits only if he or she completes the services as reflected in the agreement. These services are not the regular services of the physicians, which are listed in each doctor's employment contract with the hospital. The case file did not reflect the regularity with which the consulting services required in the plan were to be performed or the actual amount of time spent, if any, in the performance of these services.

In this case, we questioned whether the amounts deferred were truly subject to a substantial risk of forfeiture. From the information contained in the file, it was impossible for us to substantiate the regularity or amount of time to be spent in the performance of the services listed, or, indeed, if any time would be spent on the performance of these services. Even if the employee were performing the services listed, if the services required an insignificant time expenditure, they might NOT be SUBSTANTIAL, and the risk of forfeiture would therefore also NOT be SUBSTANTIAL. The requirement is that substantial future services be required to be provided. We believe this refers to the quantity of services rendered during a specific time period. Full-time services are not necessarily required. However, mere consulting availability or sporadic consulting are not substantial and neither is a cursory review of a few patient files.

The final determination, however, is based on a facts and circumstances analysis. Thus, each individual arrangement must be reviewed separately. Our conclusion in this case was that absent detailed evidence with regard to the amount of time spent on these services, the services are not substantial, and the income deferred should be currently taxable to the doctor-participant. In summary, these kind of arrangement should be reviewed very thoroughly in order to determine whether the purported substantial risk of forfeiture actually exists. It isn't enough for a plan to merely state that a substantial risk of forfeiture exists.

#### **D. Salary Reduction Ineligible Plans.**

Another area of concern is ineligible arrangements consisting of only salary reduction contributions. Typical 457(f) plans are used as a means of placing "golden handcuffs" on executives by conditioning retirement benefits on long term service, or bonuses for shorter periods of service. These amounts usually constitute additional compensation to the employee and do not place the employee's regular compensation at risk.

Salary reduction 457(f) plans, however, must be placed under closer scrutiny because few employees would find such arrangements acceptable alternatives to current compensation, unless they are very near retirement and feel secure in their jobs. Even a doctor who is highly compensated is unlikely to place a substantial amount of his income at risk. Each such type of arrangement requires looking at all the facts and reviewing whether the receipt of the compensation is really being conditioned on the future performance of substantial services.

#### **E. Rolling Risk of Forfeiture.**

Another feature of an ineligible arrangement worth close scrutiny is what is known as a rolling risk of forfeiture. A rolling risk of forfeiture is generally a provision in an arrangement that permits a unilateral voluntary extension of the period of forfeiture by the employee. In general, the deferred compensation is includible in the gross income of that employee when the period of risk lapses. The ability to extend the risk period is intended to permit the employee to further delay the receipt of compensation to a future date, and avoid taxation on the amounts until that future date.

The Service will not rule favorably on plans that have a rolling risk of forfeiture provision. When examining these plans, they should be subjected to close scrutiny to determine whether a risk really exists. This is particularly true where the employee has a recurring or frequent option to extend the risk period, or one under which the employee can extend the period shortly before the risk lapses. If you conclude that there is no risk, deferrals are subject to immediate taxation.

## **F. Multiple Plans.**

An employer may simultaneously maintain several different types of plans. For example, an employer may sponsor a death benefit plan and a severance pay plan, which, if "bona fide," are excepted from the provisions of section 457(b) (See section 5), in addition to a section 457(f) plan. However, when viewed together, it may become apparent that the benefits paid from one plan offset benefits lost under the provisions of one of the others. If this is the case in one of the plans, while it may appear that there is a substantial risk of forfeiture, it is unlikely that a true risk of forfeiture exists since a participant will receive benefit payments under one or another of the plans in all events.

## **G. Defined Benefit Section 457(f) Plans.**

Certain taxpayers have posited that the new proposed regulations under section 3121(v)(2) which apply to defined benefit plans for purposes of the FICA tax should also be applicable for defined benefit plans for purposes of the INCOME tax. The proposed regulation under section 31.3121(v)(2)-1(e)(4) provides that notwithstanding the general rule applicable to nonqualified plans under 3121(v)(2) of the Code, an amount deferred under a nonaccount balance plan is not required to be taken into account as wages ...until the first date on which all of the amount deferred is reasonably ascertainable. Under the proposed regulation, the amount deferred is considered reasonably ascertainable on the first date on which the only actuarial or other assumption regarding future events or circumstances needed to determine the amount deferred are interest, mortality and cost-of-living assumptions. If these are the only assumptions regarding future events or circumstances, then the amount deferred will not fail to be reasonably ascertainable merely because the exact amount deferred cannot be readily calculated as of that date.

This interpretation of the interplay between section 457(f) and the proposed regulations under section 3121(v)(2) is completely at odds with the requirements under section 457(f) that compensation deferred under section 457(f) arrangements is includible in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture. A defined benefit section 457(f) plan must be established in a manner which permits for the reasonably ascertainable calculation of amounts that can be taxed at the time there is no longer a risk of forfeiture of the amounts under the plan. Taxpayers cannot further defer amounts that have vested by claiming the amounts deferred are not then reasonably ascertainable. Section 457(f) plans are deferred INCOME plans, not deferred FICA plans.

Examiners should also inquire whether the actuarial assumptions being used by a defined benefit plan to determine the the amount includible in income upon vesting are the same actuarial assumptions being used to determine the value of distributions under the plan. For example, if a plan uses a higher interest rate assumption to determine the amount includible in income upon vesting than is used to determine the value of a distribution, then the amount includible in

income will be less than the amount that is actually distributed to a participant under the plan, resulting in an unwarranted tax benefit to the participant.

Any defined benefit section 457(f) plans established in this manner should be carefully reviewed and/or forwarded to Counsel.

## **H. Taxation of Section 457(f) Plans**

### **(1) Income Tax:**

Compensation deferred under 457(f) arrangements is includible in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture. The tax treatment of any amount subsequently paid or made available under the plan to a participant or beneficiary is determined under section 72 of the Code, relating to the taxation of annuities. The legislative history of section 457 and the regulations provide that earnings credited on compensation deferred under the agreement or arrangement are includible in the gross income of the participant or beneficiary only when paid or made available, provided that such interest in the assets (including amounts deferred under the plan) of the entity or employer is not senior to the entity or employer's general creditors. Section 1.457-3(a)(1),(2) and (3) of the Regulations. Thus, amounts deferred are taxed when the risk lapses, but earnings on such amounts are taxed when paid or made available.

### **(2) Employment Taxes:**

Sections 3121(v) controls the timing of the payment of FICA tax for purposes of section 457(f) plans. Section 3121(v)(2) provides generally that any amount deferred under a nonqualified deferred compensation plan is taken into account for purposes of these employment taxes as of the later of when the services are performed, or when there is no substantial risk of forfeiture of the rights to such amounts.

## **4. GRANDFATHERED PLANS OF TAX EXEMPT ORGANIZATIONS.**

### **A. Section 1107 exception from the section 457 rules.**

Section 1107 of the TRA of 1986 amended section 457 of the Code to apply its restrictions and limitations to the unfunded deferred compensation plans maintained by non-governmental tax-exempt organizations, effective for taxable years beginning after December 31, 1986, except as provided under section 1107(c) of the Act. Section 1107(c)(3)(B) addresses non-governmental tax-exempt organizations only and provides that section 457 does not apply to

amounts deferred under a deferred compensation plan of such an organization that:

- (i) were deferred from taxable years beginning before January 1, 1987, or
- (ii) are deferred from taxable years beginning after December 31, 1986, pursuant to an agreement that
  - (I) was in writing on August 16, 1986, and
  - (II) on such date, provides for a deferral for each taxable year covered by the agreement of a fixed amount or of an amount determined pursuant to a fixed formula.

Section 1107(c)(3)(B) further provides that if there is any modification of the fixed amount or fixed formula, section 457 applies to any taxable year ending after the date on which the modification is effective.

#### **B. Notice 87-13 guidance.**

Notice 87-13, 1987-1 C.B. 432, gives guidance, in the form of questions and answers, with respect to certain provisions of the Act, including section 1107.

A deferral with respect to an individual is treated as fixed on August 16, 1986, to the extent that a written plan on such date provided for such deferral for each taxable year of the plan and such deferral was determinable on such date under written terms of the plan as a fixed dollar amount, a fixed percentage of a fixed base amount (e.g., regular salary, commissions, bonus, or total compensation) or an amount to be determined by a fixed formula. An example of a fixed formula is a deferred compensation plan that is in the nature of a defined benefit plan under which the deferred compensation to be paid to an employee in the future (e.g., on or after separation from service) is in the form of an annual benefit equal to 1 percent of each of the employee's years of service with the employer times the employee's final average salary.

Q&A-28 of Notice 87-13 further provides that an amount of deferral pursuant to a written plan on August 16, 1986, will cease to be treated as fixed on such date, and thus will be subject to section 457, as of the effective date of any modification to the written plan that directly or indirectly alters the fixed dollar amount, the fixed percentage, the fixed base amount to which the percentage is applied, or the fixed formula.

Certain plan amendments do not affect the grandfathered status of a plan. For example, the election by a participant of an alternative payout option that does not alter the total amount credited to a participant under the plan for any fiscal year or the allocation of the total credits among the participants for any fiscal year is not a violation of this provision. Additionally,

changes to a plan's benefit commencement date, or modifications or clarifications to plan definitions would not cause a plan to lose its grandfathered status. We have also allowed changes to the plan that reduce the amount to be paid to a participant under the plan.

### **C. New participants not grandfathered.**

Section 1011(e)(6) of TAMRA amended section 1107(c)(3) of TRA '86. The TAMRA amendment clarified that: (1) the grandfather rule applies to any deferred compensation plan of a tax-exempt employer that otherwise meets the requirements described above, whether or not the plan would be an "eligible deferred compensation plan" within the meaning of section 457(b); and (2) the grandfather rule applies only to individuals who were covered under the plan and agreement on August 16, 1986, and not to new employees or participants. S. Rep. No. 445, 100th Cong., 2d Sess. 148 (1988).

### **D. Reviewing grandfathered plans.**

When reviewing a so-called grandfathered plan, it is important to determine whether there have been any amendments to the plan that affect the fixed amount or formula requirement. For example, any election, annual or otherwise, which permits the participant to change the amount of his salary reduction deferral, obviously violates this requirement. Also, note whether the plan has new participants and whether they are participating in the grandfathered plan. If a plan loses its grandfathered status, amounts deferred under the plan that are not subject to the requirements of sections 457(b)-(d) are included in the gross income of the participants in the year the plan is no longer grandfathered. Any questions concerning whether a modification exists should be forwarded to Counsel.

## **5. BONA FIDE VACATION, SICK LEAVE, COMPENSATORY TIME, SEVERANCE PAY, DISABILITY PAY AND DEATH BENEFIT PLANS EXCEPTED FROM SECTION 457 UNDER SECTION 457(e)(11) OF THE CODE**

### **A. The issue.**

Section 457 applies to all plans, both elective and nonelective, providing for the deferral of compensation. Since TRA '86, this has focussed attention on whether it should apply to a variety of plans that arguably defer compensation yet are not typically considered deferred compensation plans. These include a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan maintained by a state or local government or tax-exempt organization.

## **B. Service guidance.**

In Notice 88-8, 1988-1 C.B. 477, the Service stated that:

[A] bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan maintained by a state or local government or tax-exempt organization will not be subject to the provisions of section 457 for taxable years of employees beginning before the issuance of guidance describing the extent to which these forms of compensation are subject to section 457. The exemption applies to such plans whether they are elective or nonelective.

In Notice 88-68, 1988-1 C.B. 556, the Service announced that the types of plans described in Notice 88-8, including bona fide severance pay plans, would not be treated as deferred compensation plans subject to section 457 when regulations were issued. The Notice also stated that this rule would apply without regard to whether such plan is elective or nonelective in nature. The Notice concluded with a comment that "{a} number of issues remain with respect to section 457, including when a vacation leave, sick leave, compensatory time or severance pay plan is bona fide, and not a mere device to provide deferred compensation." (Emphasis added).

## **C. Advantages of Bona Fide plan.**

The advantage of having a plan qualify as a "bona fide" plan excepted from section 457 is that it may provide benefits in excess of the \$7,500 deferral limit for eligible 457(b) plans and the amounts deferred need not be subject to a substantial risk of forfeiture as is otherwise required under 457(f). In fact, the benefits provided may amount to 10 to 20 times the annually permitted deferral under an eligible section 457 plan, or even more. However, if such a plan is found to be a deferred compensation plan subject to section 457(f), then any amounts that are not subject to a substantial risk of forfeiture are currently taxable to the participant, for both income and employment tax purposes.

## **D. Section 457(e)(11).**

Section 457(e)(11) of the Code, enacted as part of TAMRA, provides that "{a}ny bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan shall be treated as a plan not providing for the deferral of compensation." The legislative history of TAMRA indicates that this section was intended to codify Notice 88-68, but provides no further explanation. The Service has not yet provided any interpretative guidance on Section 457(e)(11).

Remember, however, that the substance is what matters. Thus, the mere label, title or other designation of one of these plans as "bona fide" under 457(e)(11) is meaningless if the benefit package provided, as well as the spirit of the plan, is more in the nature of a deferred compensation plan.

### **E. Review of plans.**

Any arrangement of a state or local government or tax exempt employer that is clearly equivalent to a nonqualified deferred compensation plan should be viewed as being subject to section 457 regardless of whether the plan is labelled otherwise. When reviewing section 457 plans generally, be sure to inquire whether the employer has a sick leave, vacation leave, severance, disability or death benefit plan, in addition to any section 457 plans. A review of the plan documents may indicate that these plans are not really excepted from the provisions of section 457. Look beyond what the plan says and see what it does. If the plan resembles a section 457 plan, question its status as a plan exempted from section 457.

For a detailed article on severance pay plans and how to distinguish between severance pay plans and plans of deferred compensation, please see the article entitled, Severance Pay Plans of State and Local Government and Tax-Exempt Employers, found in the Exempt Organizations Continuing Professional Education, Technical Instruction Program for FY 1996, Topic H, page 182.

### **6. SECTION 457(e)(12) NONELECTIVE PLANS FOR INDEPENDENT CONTRACTORS.**

Section 457(e)(12)(A) provides that section 457 does not apply to nonelective deferred compensation attributable to services not performed as an employee. For purposes of subparagraph (A), deferred compensation is to be treated as nonelective only if all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship to the payor are covered under the same plan **with no individual variations or options under the plan.** Section 457(e)(12)(B).

In the absence of regulations interpreting this section, a literal reading should be applied. For example, no individual variations or options in the plan can exist. Furthermore, when looking at the relationship of the independent contractors to the entity, make sure the same classes of independent contractors are grouped together, and not arbitrarily separated. For example, one case we reviewed separated every medical subspecialty of doctors into a different subgroup for purposes of applying individual variations and options under the plan. However, there were only one or two doctors with each subspecialty on staff, and not a whole group of specialists. We viewed each individual doctor as having the same relationship to the hospital, and no individual variations or plan options should have been permitted. This plan, therefore, should have been subject to section 457. A different conclusion might have been reached if each subspecialty consisted of several doctors and there were rational, objective differences in these relationships, as may be found at a large hospital.



## 7. CONCLUSION.

There are several kinds of plans of state and local government and tax-exempt employers that fall under the requirements of section 457. A thorough review of all the factors discussed in this article will be necessary to determine whether the plans are in compliance with section 457. If the provisions of the plan appear to be in compliance with the requirements of section 457, a review of the administration of the plan may still uncover problems which merit a further analysis of the tax effects of the plan. If the plans of these employers purport not to be subject to section 457, it is still necessary to determine whether they are truly exempt from section 457 or just exempt in name only. If a plan looks like a plan that should be subject to the requirements of section 457, question whether it has been characterized appropriately.

## 8. ADVICE FROM COUNSEL.

Any questions concerning section 457 can be directed to the Office of the District Counsel/Associate Chief Counsel, Tax Exempt and Government Entities, Qualified Plans Branch 2, at (202) 622-6060.

Counsel also has a publication and Video which deal more generally with the subject of nonqualified deferred compensation entitled **MORE THAN BASICS: THE BASICS OF EXECUTIVE COMPENSATION** (Document 9251, Catalog Number 20746X.) The Publication and Video can be ordered through your Administrative Office from the Centralized Inventory Distributions Systems (CIDS) at 1-800-829-2437, which services all areas from the Sacramento, California, Bloomington, Illinois, and Richmond, Virginia service areas.